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Money from Heaven: Should Qualified Air Rights Donations Be Characterized as Interests in Land or Buildings - Why Does It Matter

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MONEY FROM HEAVEN: SHOULD QUALIFIED AIR RIGHTS DONATIONS BE CHARACTERIZED AS INTERESTS IN LAND OR BUILDINGS? WHY DOES IT MATTER?

I. INTRODUCTION

Due to financing shortfalls, it is often more feasible to raze a building than it is to renovate it. Historic districts in many of America's urban centers bear silent witness to this reality. Property owners and developers have felled famous theaters, factories, and turn of the century hotels. Like anyone else, they naturally act in self-interest by making the "best" use of their land with the limited financial means at their disposal. Unfortunately, that use is not always in the interest of the public.

As part of an effort to encourage the preservation of historic and natural resources, the federal government has created tax incentives for real estate owners

who preserve land and structures by donating qualified conservation easements to non-profit or government entities.[1] Perhaps, Congress realized the self interested motives of cash strapped owners; perhaps, Congress realized that some of their own regulations facilitated the demise of history.[2]

Whatever the motivation, the enactment of laws and promulgation of tax regulations pertaining to deductions for the donation of conservation easements does create powerful new means by which developers may secure financing to preserve historic buildings. In a shining moment of brilliance, the federal government has harnessed the self-interest of "philanthropic" property owners to generate public benefit.

The most obvious benefit for the donors of conservation easements is the deduction to taxable income made available by Section 170(h) of the Internal Revenue Code (I.R.C.).[3] The tax regulations are sparse in describing how a donor of an easement is to adjust the basis of retained assets after this deduction.[4] There is only limited guidance for determining the appropriate method for attributing basis adjustments to land, building, development rights, air rights, and renovation costs.

Traditionally, the I.R.C. and the Treasury Regulations separate real property into the basis accounts of land, building, and rehabilitation costs.[5] When determining a basis adjustment, the I.R.C. requires that the appropriate basis account be adjusted for changes in value of any given asset.[6] This raises the question of whether the donation of air rights should trigger a basis adjustment to the property as a whole, or just to one of the aforementioned capital accounts.

Currently, the Internal Revenue Service (hereinafter I.R.S.) and the federal courts do not offer specific positive authority as to whether large amounts of easement value from donated air rights can be allocated against the capital account of "land" as

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[1]STAFF OF THE JOINT COMM. ON TAXATION, 94th CONG., General Explanation of the TAX REFORM ACT OF 1976, 643 (December 29, 1976). ("Congress believes that the rehabilitation and preservation of historic structures and neighborhoods is an important national goal. ongress believes that the achievement of this goal is largely dependent upon whether private funds can be enlisted in the preservation movement. Tax considerations have an important bearing on whether private interests are willing to maintain and rehabilitate historic structures rather than allow them to deteriorate or replace them with new buildings. It has been argued that certain tax provisions of prior law encouraged the demolition and replacement of old buildings instead of their rehabilitation").

[2]*Id.* "In particular, it has been argued that discrimination against preservation efforts existed under prior law because (1) the expenses of demolishing an old building and the remaining undepreciated basis of the demolished building were deductible unless the building had been acquired with a view towards its demolition and (2) more favorable depreciation methods were allowed with respect to expenditures incurred in the construction of new structures than those incurred in the rehabilitation of existing structures." *See also* I.R.C. § 280B (2001) for provisions relating to the deductibility of demolition.

[3]I.R.C. § 170(h) (2001).

[4]STEPHEN J. SMALL, THE FEDERAL TAX LAW of CONSERVATION EASEMENTS § 17-15 (4th ed. 1997).

[5]I.R.C. § 1001 (2001); *See also* Gen. Couns. Mem. 39794, 6 (1989).

[6]*Id.*

opposed to a "building" on a given tract of real estate.[7] A lack of authority in this area creates uncertainty in the real estate market. This uncertainty is not only with the payment of federal income, estate, and gift taxes, but it also has a ripple effect with the assessment of local property taxes.[8] Most importantly, if a deal is on the line, uncertainty can mean the difference between saving a landmark or welcoming a new parking lot. This Note will examine what methods of basis allocation are possible under current tax law.

Part I of this note will establish modern jurisprudence relating to the concept of air and development rights. Part I will also clarify the current state of federal tax law pertaining to the donation of conservation easements, depreciation of assets, and the allocation of basis after an exchange of property. Part II of this note will analyze the relation between the I.R.C., I.R.S. rulings, case law, air and development rights jurisprudence, and the economic consequences of conservation donations. This note will conclude by asserting that under the I.R.C. and the Treasury Regulations, qualified conservation easements which grant air rights to a third party should, for purposes of the relevant assets, affect an adjustment to the "land" account and not the account of a building, which incidentally shares the same tract of real estate. By deducting the value of a donated easement from the "land" account, a property owner can still utilize a depreciation deduction against the value of the building that lies on the same parcel of real estate as the air or development rights.

II. THE EASEMENT

A. Real Property, Easements, Development Rights and Air Rights

1. Brief Common Law History

The real estate interest, now commonly referred to as an easement, arose as a legal concept during the nineteenth century.[9] The transition from field crops to livestock, which occurred during that time, required the erection of fences and enclosures.[10] These barriers interfered with what were once common rights of way and travel.[11]

The concept of an easement is thought to be an English legal response to the then burgeoning livestock industry.[12] An easement is a lesser interest in land that is carved out of the "fee" or whole interest in a parcel of real property.[13] It confers the

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[7] *Id.*

[8] *See* SMALL, *supra* note 4, at § 17-15.

[9] JESSE DUKEMINIER & JAMES KRIER, PROPERTY 728 (4th ed., 1998).

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] SMALL, *supra* note 4, at § 2-5(.05). "An easement is a limited right, granted by the owner of real property, to use all or part of his property for specific purposes. A traditional legal use of an easement, for example, has been for owner A, on whose property a stream flows, to allow neighbor G to cross A's property in order to take water from A's stream").

right to use, or prevents the use of that property, for certain purposes.[14] An easement does not convey the entire interest in a tract of real property, only the rights specified by an agreement or deed.[15] It is helpful to look at easements as if they were a right only after they are created and given to another. From this perspective, any idea that can be put onto paper could eventually constitute a basis for establishing an easement in real property.

In order to gain an understanding of this concept, one has to look at an easement as one stick in the "bundle of rights" that a property owner possesses.[16] This "stick" may be sold to another while the owner still retains his bundle, or the rest of his rights in the land.[17] Easements are typically classified as either: negative, such as the right to prevent someone from tearing down a building facade on their land; or affirmative, such as the right to discharge water from your land onto the estate of another.[18] Those categories can be further subdivided into particular interests and rights in property.[19] Air rights easements have a negative effect on the ability of the fee owner of land to exercise the particular right to develop portions of air space above, or sometimes even below the land.

2. Principle Types of Easements Involved in Historic Preservation

Of the aforementioned types of easements, there are three forms commonly used in historic preservation: facade easements, development rights easements, and air rights easements. These easements may have different characteristics than traditional easements.[20] Additionally, conservation easements are usually negative in character, as they are designed to prevent someone from doing something with their land.[21] An understanding of federal tax law regarding classification of these easements is important.

For tax purposes, the facade easement is associated with the outer structure of a building. In a nutshell, it is a restriction that prevents the fee owner of the property from altering, damaging, or destroying the outer walls of a building.[22] When a

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[14]BLACK'S LAW DICTIONARY 215 (1996).

[15]*Id.*

[16]Kaiser Aetna v. United States, 444 U.S. 164, 176 (1979); *See also* Rev. Rul. 83-59, 1983-1 C.B. 103 (1983).

[17]*Id.*

[18]*See* BLACK'S LAW DICTIONARY, *supra* note 14 at 215.

[19]*Id.* Other classifications include air rights, development rights, access rights, light rights, and aviation rights (fly overs).

[20]*See* SMALL, *supra* note 4, at 2-6(.05). ("Easements for conservation purposes touch a different set of rights, the property owner's right to develop, improve, or modify his property and the buildings on it, generally as he sees fit. An easement for conservation or preservation purposes involves the relinquishment of some of these rights").

[21]*Id.*

[22]*See*, *e.g.*, Rome I Ltd. v. Comm'r, 96 T.C. 697 (1991) (dealing with recapture of tax credits after the donation of a facade easement.)

taxpayer donates a facade easement to a qualifying conservation organization, that taxpayer is required to allocate the resulting reduction in basis between the building and the underlying land.[23] This rule indicates that the I.R.S. views facade rights easements as an encumbrance on both the land and the building to which it pertains.

The development rights easement restricts the rights of the fee simple owner of the land. It prevents an owner from developing land, adding structures, or constructing a vacant space.[24] Essentially, it is a restriction on a fee owners right to develop land.[25] Alternatively, these easements may restrict the use of land to hunting, fishing, or farming.[26] They may also delineate permissible building uses and the size of new buildings.[27]

Development rights easements are often negative and designed to encumber private use.[28] In some cases, however, the donation of a development rights easement is done with the intention of having another party develop and use the encumbered fee property for purposes that the donor intended.[29] For example, an owner of a forty-acre ranch in Colorado wants the back twenty acres to be developed into a house for his oldest daughter, with most of the acreage preserved as open space. The owner could donate those specific development rights to a third party: his daughter, who would build on the site. This use would have less developmental impact on the ranch as a whole.

Air rights easements are a subset of development rights easements. Air rights easements can be viewed as a specific form of development rights easement that restricts the development or erection of structures into air space appurtenant to a tract of land.[30] The sub-classification of air space has been recognized by the Tax Court

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[23]Treas. Reg. § 1.170A-14(h)(3)(iii) (amended 1999).

[24]Estate of Gibbs v. Comm'r, 161 F.3d 242 (3d. Cir. 1998). Part of the value of real property is the right relating to development uses of the property.

[25]*See generally* SMALL, *supra* note 4.

[26]*See generally* Strausburg v. Comm'r, 79 T.C.M.(CCH) 1697 (2000).

[27]Rev. Rul. 77-414, 1977-2, C.B. 299 (1977).

[28]*See* BLACK'S LAW DICTIONARY, *supra* note 14, at 215.

[29]Mattie Fair v. Comm'r, 27 T.C. 866 (1957). ("Petitioners, owners of a commercial lot with a 2-story building thereon located in Tyler, Texas, conveyed, without consideration to the Foundation, a charitable corporation, the perpetual right to build, own, and maintain 5 additional stories on the existing 2-story building, plus the rights of access and support. In this case, the development right is also an air right. It pertains to a specific imaginary box of space. It is delineated in length and width by the dimensions of the building which already exists, and in height by the term '5 stories'").

[30]*Id.*

as one of the rights in land.[31] There are state statutes that also support this argument.[32]

In at least forty-six states, the donation of development rights easements to conservation organizations has become a valuable tool in natural and historic resource preservation.[33] Development right easements donated to non-profit organizations benefit the public by preserving historic buildings. In many cases, these non-profit organizations do not have the resources to acquire urban real estate parcels in fee. An easement, which restricts a donor from altering or destroying a building, is a necessary alternative. From the donor's perspective there are benefits as well. An easement occupies a more acceptable measure of restriction over land rights than would occur under direct government intervention.[34] Once in their hands, conservation organizations may hold easements forever, regardless of whether or not the original donor's retained fee interest in the property changes hands.

B. The Qualified Conservation Easement Under §170 of the I.R.C.

1. Tax Requirements for Deductibility

The I.R.S. gives favorable tax treatment to taxpayers who utilize qualified conservation easements as a means of preserving natural and historic features.[35] These tax benefits are sometimes great enough to skew a developer's cost-benefit analysis in favor of preserving land and buildings.

The I.R.C. allows taxpayers to deduct from income, the value of property that they donate to charitable or governmental organizations.[36] A deduction under these provisions is generally not allowed for transfers of real property that are less than a

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[31]*Id.* "The right to use the air space superjacent to the ground is one of the rights in land." There was further elaboration that air rights were not only a right in land, but in many cases the most important right. *Id*.

[32]CONN. GEN. STAT. § 47-42 (2000). Dealing with easements for public utilities, the Connecticut assembly enacted a provision which states, "any right of way over or easement in or to any land…granted…by any means of an instrument executed in the manner provided by law for conveyance of any interest in real estate, which instrument purports to convey to … any corporation … a right of way over or easements in or to such land … for any purpose connected with the generation, transmission or distribution of electric energy … shall create a transmissible and assignable interest in the land in the grantee therein described." *Id.*

[33]JANET DIEHL & THOMAS S. BARRETT, THE CONSERVATION EASEMENT HANDBOOK 1 (1988).

[34]*Id*. at 2.

[35]I.R.C. § 170(a)(1) (2001).

[36]*See generally* I.R.C. § 170 (2001).

taxpayers entire interest in that property.[37] An exception to this rule is carved out for the donation of a "qualified conservation contribution."[38]

Three conditions must be met in order to establish a qualified conservation contribution.[39] A donated land interest must be a "qualified real property interest."[40] By I.R.S. standards any interest that is not (1) the entire interest in a parcel of real property; (2) a remainder interest; or (3) a restriction of use made in perpetuity, will not qualify under this section.[41] The interest must be made to a "qualified organization."[42] Essentially, the I.R.S. requires that a donation be made to a non-profit organization, charitable trust, private foundation, or governmental organization.[43] Once it is determined that an easement is a qualified real property interest that is made to a qualified organization, the last test is to determine whether it is made exclusively for conservation purposes.[44]

There are four purposes that the I.R.S. recognizes as "conservation purposes."[45] They are: 1) to preserve land for enjoyment or education of the public; 2) to protect biological habitat; 3) to preserve open space for scenic or other clearly delineated policy; or 4) to preserve historically important land or certified historic structures.[46] Having satisfied any one of the aforementioned criteria, an easement donation will qualify for a tax deduction.[47]

For a further definition of what constitutes a historic structure, the Treasury Regulations are helpful.[48] In order to be classified as "historic," a building must either be listed on the National Register for Historic Places, or have the Secretary of the Interior's approval for contributing to the historic character of a registered historic district.[49]

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[37]I.R.C. § 170(f)(3)(A) (2001); *See also* Treas. Reg. § 1.170A-6 (as amended 2001) (relating to charitable contributions in trust); Treas. Reg. § 1.170A-7 (as amended 1994) (relating to contributions not in trust of partial interests in property.)

[38]I.R.C. § 170(f)(3)(b)(iii) (2001), *see also* SMALL, *supra* note 4, at 2-2. ("As far as Congress and treasury are concerned, a taxpayer who donates an easement continues to use and enjoy the property, and the requirements for taking an income tax deduction simply must be tighter to ensure that there is also a significant long-term public benefit associated with the donation"). *See* SMALL, *supra* note 4, at 2-2.

[39]I.R.C. § 170(h)(1) (2001).

[40]I.R.C. § 170(h)(1)(A) (2001).

[41]I.R.C. § 170(h)(2) (2001).

[42]I.R.C. § 170(h)(1)(B) (2001).

[43]I.R.C. § 170(h)(3) (2001).

[44]I.R.C. § 170(h)(1)(C) (2001).

[45]I.R.C. § 170(h)(4)(A) (2001).

[46]I.R.C. § 170(h)(4)(A)(i)-(iv) (2001).

[47]I.R.C. § 170 (2001).

[48]Treas. Reg. § 1.170A-14(d)(3).

[49]*Id.*

2. Valuation Requirements

Valuation issues are also extremely important when analyzing conservation easement donations.[50] Congressional wariness over abuse of qualified conservation easement donation provisions stems largely from fear of inflated deductions relating to overstated values for donated rights.[51] The flip side of this problem is when owners do not appreciate the true loss that their property suffers upon donation, they may reduce the amount of their deduction. There are statutory and regulatory safeguards that prevent either of these occurrences from happening.

Any discussion in this area must begin with a recitation of the "willing buyer/willing seller" rule.[52] "Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell land and both having a reasonable knowledge of the relevant facts."[53] In disinterested transactions, this rule usually prevents large deviations in value from the "norm."

Under a "typical" easement deal, the before and after valuation method is used to establish what an easement is worth, relative to the parcel it encumbers. This rule, however, only serves as the preferred rule; other methods may be used.[54] This process begins by determining what the "highest and best use" of the property was without the easement.[55] Treasury Regulations require that one not only take into account the value of the property, but also the likelihood that further development would occur on it.[56] This provision enables property owners to potentially be able to deduct the value of their contribution that exceeds what they paid for land in the same year.

Allowing the likelihood of future development to factor into the equation also adds to the difficulty of determining an established market price may be for such

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[50]*See* SMALL, *supra* note 4, at Ch. 17; *see*, *e.g.*, Dorsey v. Comm'r, T.C.M. 592 (1990).

[51]*See* SMALL, *supra* note 4, § 17-15 n.2.1. ("for a taxpayer who does not have the present intention to sell or develop the property, the gift of, for example, a conservation easement, while perhaps diminishing the value of the property, does not do so until a later date; in particular, it may have no material impact on the continuing enjoyment of property by the donor of an easement").

[52]Treas. Reg. § 1.170A-1(c)(as amended 1996).

[53]*Id.*

[54]S. REPT. NO. 96-1007, at 15-16 (1980). "Conservation easements are typically, but not necessarily, valued indirectly as the difference between the fair market value of the property involved before and after the grant of the easement." *Id.* ("Where this test is used, however, the committee believes it should not be applied mechanically"). *See* Rev. Rul. 73-339, 1973-2 C.B. 68 (1973), Rev. Rul. 76-376, 1976-2 C.B. 53 (1976).

[55]Hillborn v. Comm'r, 85 T.C. 689 (1985). To determine the value of property before an easement donation, one has to take into account "what the property's highest and best use could have been." *Id.*

[56]Treas. Reg. § 1.170A-14(h)(3)(ii) (as amended 1999).

land interests.[57] The reason why "highest and best use" will become important later in this Note is that such characterization of value opens the door for high assessments of property. For example, a developer could buy a fee interest in land with a two story building for $1 million. After determining that the "highest and best use" of that land would be for the erection of a 40-story structure, the development rights in that land could be valued at $800,000![58] In reality, it is not that simple; however, this example highlights the importance of why developers want to target the adjustment of the basis of their retained assets after giving a qualified conservation contribution. Conversely, the Tax Court has stated that there may be some cases in which the right to build on top of an existing structure may convey no value at all.[59]

3. Additional Considerations

Aside from the obvious deduction provisions established in I.R.C. § 170, there are some other benefits available to conservation easement donors.[60] These benefits can include a reduction in local property tax.[61] Additionally, there are estate and gift tax benefits available to donors of qualified conservation contributions.[62] An owner of property must also consider whether historic tax credits have been taken for a parcel, as some I.R.S. rulings require recapture of some of that value.[63] Lastly, before donating an easement, property owners must make sure that they are willing

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[57]*See*, *e.g.*, Symington v. Comm'r, 87 T.C. 892, 895 (1986) (stating that because easements are frequently gifted, it is often hard to ascertain market prices for them).

[58]SMALL *supra* note 4, at 17-6, (using a federal agency's actions as means of validation, potentially against I.R.S. arguments to the contrary, the author states "it is not uncommon for the National Park Service to pay 60% to 80% of the fair market value of a property for an easement on that property").

[59]*Mattie Fair*, 27 T.C. at 874. Here, the court notes that it is impracticable not feasible to build in some locations. No specific examples are given, however, as to where this may be the case.

[60]John Goveia & James Jurinski, *Expanded Benefits for Conservation Easements Can Provide Substantial Income and Estate Tax Savings*, JOURNAL OF REAL ESTATE TAXATION 106.

[61]MICHAEL J. GOLDBERG, *Taxes Don't Have to Expand When Business Does, 91 Tax Notes* at 2203. (June 19th 2001). While discussing depreciation, the author notes that many states compute their own real estate tax based on federal taxes.

[62]26 U.S.C.S. § 2055(f) (Law. Co-op 2003); 26 U.S.C. 2522(d) (2003). Estate Tax and Gift Tax have mirror provisions dealing with deductions relating to the donations of easements in real property. These provisions require that an easement must satisfy the requirements of § 170(h) in order to be eligible for the deduction. *Id.*

[63]*See* Gen. Couns. Mem. (July 13, 1989). 39,794. For a while, the I.R.S. held that donation of a historic easement would not trigger recapture of previous historic tax credits. *See* Tech. Adv. Mem. 87-36-003 (May 12, 1987) . In a revenue ruling, the I.R.S. reversed its prior position with respect to the recapture of tax credits. *sSee* Rev. Rul. 89-90, 1989-2 C.B. 3. This position was the reaffirmed by the Tax court holding in Rome I Ltd. v. Comm'r, 96 T.C. 697 (1991). *Rome* involved a qualified conservation contribution of a facade easement to a non-profit. *Id.* The Tax Court treated the donation of an easement as a "disposition of property" sufficient to trigger recapture. *Id.*

to deal with the encumbrances that are required under tax regulations, particularly with respect to public access.[64] All of these aspects must be taken into account by the would be donor considering the donation of a qualified conservation contribution easement.

C. Basis Adjustment

Once a real estate owner determines that he qualifies for a conservation easement deduction, the next logical step is to ascertain how the law requires an owner to apportion the deduction among the building and the land for a given tract of real estate. Should the reduction in value from the donation of the air rights property interest be allocated between the building and the land, in a pro-rata fashion? Or perhaps the proper methodology should be to directly trace the value to either the building or the land. Each of these two methods of apportioning basis will have a different effect on the total deductibility of a property owner's assets.

In both a sale transaction involving real property and a qualified air rights easement donation, there is a reduction in the value of the property interest that must be accounted.[65] The primary distinction between the two situations is that money is received in the case of a sale. This Note does not address the income of cash or other property. Assuming the transaction is at arms length, it would be illogical for the I.R.S. to rule otherwise based on the differences between donee and buyer. In the case of air rights, once a property owner loses them, the interference on his fee interest is the same. We can still use our understanding of sale transactions to help explain how tax regulations treat the property that is retained after any transaction in real property. In order to comprehend tax law in this area, one must start with the regulations governing apportionment of basis after sale transactions.[66] When part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts.[67]

As a means of keeping running tabs on the acquisitions of wealth by individuals, Congress and the I.R.S. have enacted and promulgated law relating to the determination of loss or gain on the sale or exchange of assets.[68] To determine the loss on the sale or disposition of property, begin with the basis of the property, make

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[64]Treas. Reg. § 1.170A-1(e) (as amended 1996). "…In the case of a conservation easement such as an easement on a certified historic structure, the fair market value of the property after contribution of the restriction must take into account the amount of access permitted by the terms of the easement". *Id.*

[65]*See* Treas. Reg. § 1.61-6(a) (as amended 2001). The I.R.S. has well developed regulations regarding sale transactions and basis allocation, which can aid in our understanding of rules, governing qualified conservation contributions of air rights easements. *Id.*

[66]*Id.*

[67]*Id.*

[68]I.R.C. § 1001 (2001). These rules serve as a starting point for analyzing transactions which create a loss or gain on the value of property.

the proper capital account adjustments, and subtract the price for which that asset was sold or disposed.[69] Basis is simply defined as cost.[70]

Through I.R.C. provisions relating to taxable gain, it is possible to augment the effects of the Section 170 deduction. This is done by allocating the deduction against the "land" portion of a given real estate parcel as opposed to allocating the deduction against the value of the "building" that sits on the "land."

D. Depreciation

The I.R.S. has created an elaborate set of rules governing deductions from income tax for expenditures on depreciable assets.[71] By allowing developers to deduct costs for the purchase of buildings and the expenses of rehabilitation, these provisions indirectly aid the historic preservation movement. Since "land" is not a depreciable asset and therefore, not otherwise deductible, a real estate owner can double dip when he depreciates away the cost of the "building" after taking his easement deduction against the value of the "land."[72] In an urban setting, where the building and land values are high and the income deductions attributable to the donation of an air rights easement are enormous, developers are scrambling to find ways to make such deals work.

This highlights the importance of having air rights easement value allocated against the "land" account. If the entire value of an easement were allocated against the building, one would have less building value to depreciate. By allocating basis adjustment against the land, the full value of depreciation remains with the building, and can be deducted against income for a period of years.[73]

If the value of an air rights easement is allocated against the building interest, there will be less cost to depreciate from a taxpayer's overall income for any given year.[74] Additionally, the land value will not be deductible as an expense under any other provision. Because taxpayers stand to gain from depreciation, while the government loses revenue, the Tax Court places the burden on the taxpayer to prove

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[69]I.R.C. § 1011 (2001). This section addresses adjusted basis for determining gain or loss on the sale or disposition of property.

[70]I.R.C. § 1012 (2001). Among other things, this section defines basis as cost.

[71]I.R.C. § 167 (2001); I.R.C. § 168 (2001); *See also* Treas. Reg. § 1.167 (1960). These provisions deal with depreciation of property. They establish not only what types of property may be depreciated, but the method with which to depreciate the value of that property. *Id.*

[72]Treas. Reg. § 167(a)-2 (1960). Aside from natural forces like erosion, land is generally not property which is "subject to wear and tear." *Id.* Because of this, the regulations make a specific exclusion for "land, apart from the improvements of physical development added to it." *Id.*

[73]I.R.C. § 168(b) (2001). This section deals with the applicable depreciation method under the accelerated cost recovery method.

[74]*See* SMALL, *supra* note 4, at § 17-15 ("A reduction in the basis of the land is of little immediate consequence; however, a reduction in the basis of the building may be significant, because if the building is subject to depreciation, a higher basis will generate higher depreciation deductions").

that he has a depreciable interest in the property.[75] If the proper classification is not made, non-depreciability is the assumption.[76]

III. ANALYSIS

There is little authority in I.R.S. regulations or in court decisions pertaining to whether air rights should be classified as a right attached to land and not to the buildings for purposes of basis allocations. This Note examines an approach to this problem.

A. The Regulatory Vacuum Surrounding Air Rights Easements

The I.R.S. has promulgated general rules relating to qualified conservation contributions.[77] Regarding the adjustment of basis after the donation of a qualified air rights easement, Section 1.170A-14(h)(3)(iii) applies. This provision is cross-referenced from the regulations pertaining to depreciation and merits inclusion.[78]

In the case of the donation of a qualified real property interest for conservation purposes, the basis of the property retained by the donor must be adjusted by the elimination of that part of the total basis of the property that is "properly allocable" to the qualified real property interest granted. The amount of the basis that is allocable to the qualified real property interest shall bear the same ratio to the total basis of the property as the fair market value of the qualified real property interest bears to the fair market value of the property before the granting of the qualified real property interest.[79] When a taxpayer donates to a qualifying conservation organization an easement on a structure with respect to which deductions are taken for depreciation, the reduction required by paragraph (h)(3)(ii) in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land.[80]

The manner in which the I.R.S. defines "properly allocable" and "the qualified real property interest granted" will determine how an air right or a development right must be allocated. If the I.R.S. says that the air rights easement is a sub-classification of both the land and the building interest, the deduction is taken pro rata from both. Under this method, the basis reduction is bifurcated between the building and the land. On the other hand, if a direct cost tracing method is used, the I.R.S. determines one account and directly trace the cost reduction to that account. If the I.R.S. determines that the air rights easement is a qualified real property interest

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[75]Geneva Drive-In Theatre, Inc. v. Commissioner, 67 T.C. 764 (1977).

[76]*Id.*

[77]*See* Trea. Reg. § 1.170A (2002).

[78]Treas. Reg. § 1.167(a)-5 (pertaining to the Apportionment of Basis when acquiring a combination of depreciable and nondepreciable property, this regulation states "for adjustments to the basis of a structure in the case of a donation of a qualified conservation contribution under section 170(h), *see* § 1.170A-14(h)(3)(iii)"). *Id.*

[79]*Id*.

[80]*See* § 1.170A-14(h)(3)(iii) (as amended 1999).

in land, after a deduction, the value of the retained asset of land will be adjusted downward.

B. Direct Cost v. Pro Rata

1. The Allocation of Adjustments to Basis for Air Rights Easements.

Courts will recognize many different sub-classifications of real property rights.[81] For purposes of the capitalization of assets, the I.R.S. allows for the sub-classification of land and building accounts.[82] Once an air right or other interest in property is established, there must be a determination as to the principal capital account to which that right attaches.[83] This is necessary so that a proper adjustment in the basis of the retained assets can be made pursuant to the regulations.[84]

The two preferred methods for allocating basis adjustments among accountants and the like are direct cost and pro rata. By determining whether a direct cost or a pro rata method is the appropriate means of allocating basis adjustments among the retained assets after an air rights easement is donated, the stage can be set for further analysis into the sub-classification of an air rights easement into the land or building accounts. The direct cost method of accounting is one where individual values are traced to the individual subclass of property to which that value is related.[85]

Pro rata basis adjustment, on the other hand, occurs when the value of a property right is deemed to be a component of both the land and building within the fee parcel. The pro rata method requires that an adjustment to the basis of property be allocated proportionately to both the land and the building.[86] If, for example, an air right were found to be a right in land only, and if one was to use a direct cost method of basis adjustment, the entire value of a donated easement, once deducted, could be allocated against the land interest only.

Turning an air right into an easement is one thing, but adjusting the value of that easement against the proper capital account is different. With respect to air rights in particular, there are several areas of state and federal law that may shed light on this subject.

Prior to the enactment of Treasury Regulations pertaining to conservation easements, the Tax Court had ruled on several value allocation cases. In cases pertaining to the valuation ramifications of a scenic easement, the court held that the easement restrictions affected only the value of the land and not the homes that were

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[81]Mattie Fair v. Comm'r, 27 T.C. 866, 872 (1957). Judge Black opined that not only are air right, one of the many interests in real property, but potentially one of the most valuable, as most structures are erected into air space upon land. *Id.*

[82]Treas. Reg. § 1.1001 (2002); *See also* § 1.170A-14(h)(3)(iii) (as amended 1999). *Compare* (Second Class City Act), P.L. 346, *as amended*, PA. STAT. ANN. tit 53, § 25891 (2002). Pennsylvania is another example of a taxing entity, which has rules requiring classification into the principle accounts of land and building.

[83]*Id.*

[84]Treas. Reg. § 1.170A-14(h)(3)(iii) (as amended 1999).

[85]*See* BLACK'S LAW DICTIONARY, *supra* note 14, at 146.

[86]*See* BLACK'S LAW DICTIONARY, *supra* note 14, at 509.

built upon it.[87] The importance of this decision cannot be understated. If the reduction in value is entirely attributable, i.e. direct cost, to the land, the restriction cannot be said to economically reduce one's rights in a building on that land. In other words, a pro rata adjustment to the basis of the assets would be inappropriate. Unfortunately for our analysis, the court did not address the basis issue. Instead, the opinion and holding relate to valuation.

Some examples listed in the Treasury Regulations, pertaining to the allocation of basis adjustments, offer some limited guidance as to what the I.R.S. requires.[88] In one instance, the regulations are addressing a perpetual easement on a tract of land, the analysis assumes that a perpetual easement prohibits development of the land.[89] While this provision does not explain how to address the adjustment to the basis of the house and the land, it opens the door to the logical impasse. Air rights can't be considered land interests in one case and building interests in another.

Revenue Ruling 59-121 can also offer some potentially positive authority for the donation of a qualified conservation easement.[90] Another regulation provides that the consideration received for the granting of an easement constitutes the proceeds from the sale of an interest in real property and should be applied as a reduction of the cost or other basis of the land subject to the easement.[91] Even though this ruling deals with a sale of an easement there is no reason to distinguish the apportionment based on whether land is sold or given away. It is certain that the land is described as being appurtenant to the easement and there is no mention of buildings.[92]

In another revenue ruling, the I.R.S. clarified the "properly allocable" provisions found in Treasury Regulation Section 1.170A-14(h)(3)(iii) by asserting that for purposes of reduction in value from a sale, when an easement affects "only that specific portion of the entire tract of land," that is proper to allocate a reduction in basis to that portion.[93] It would seem as though the federal government was making little effort to disguise the direct-cost nature of its ruling.

There is only one case involving development restrictions where the Tax Court has addressed Treasury Regulation Section 1.170A-14(h)(3)(iii).[94] In *Dorsey v.*

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[87]Akers v. Comm'r, 48 T.C.M. (CCH) 1113 (1984). (Stating that the value attributable to ranchettes was not affected by the easement and agreed with the petitioner that the development rights easement only affects the land); *See also* Symington v. Comm'r, 87 T.C. 892 (1986). Where a development rights easement on a rural tract of land was gifted, the Tax Court held that the donation of property did not affect the value of the house, barns, etc. *Id.* For analytical purposes, air rights can be thought of as a sub-classification of development rights, so the treatment of development rights should be similar to air rights. *Id.*

[88]Treas. Reg. § 1.170A-14(h)(4) ex. 8 (as amended 1999).

[89]*Id.*

[90]*See* Rev. Rul. 59-121, C.B. 1959-1, C.B. 212 (1959).

[91]*Id.*

[92]*Id.*

[93]Rev. Rul. 68-291, 1968-1 C.B. 351 (1968).

[94]Dorsey v. Comm'r, T.C.M. (CCH) 592 (1990).

Commissioner,[95] the Tax Court primarily addressed valuation issues pertaining to the donation of a facade easement for historic preservation of a structure.[96] While the court did not directly address the issue of air rights restrictions, it did address the issue of an open space easement.[97] Because the facade restrictions in effect prevented development of what could be considered superjacent air space, the court's analysis in this area can be helpful.[98] Specifically, the judge in that case stated an open space easement involves no right to control the exterior of the building.[99] The court may have been referring to adjacent or superjacent "open space." Whatever the case, there is little doubt that this language amounts to recognition by the court that rights in space do not relate to rights in a building.

In contrast to the above holding, a Pennsylvania appeals court determined that when taxability of air rights appurtenant to condominiums is in question, it is more logical to conclude that such air rights are rights in buildings and not in land.[100] In *Bigman v. Allegheny County Board of Property Assessment*,[101] the Commonwealth Court of Pennsylvania was faced with the difficulty of classifying air rights according to the narrowly defined tax definitions of buildings and land.[102] In this case, the taxpayers owned two condominiums in the city of Pittsburgh.[103] These condominiums were part of a nineteen-story complex.[104] The land under the condos was owned by a separate entity and that party was the subject of "millage rate" taxes applicable to real property within the city of Pittsburgh.[105] Like in many cities, the millage rate on land is significantly higher than it is on buildings.[106] In *Bigman*, the taxpayers were arguing that they owed no tax on the land, because their condominium represented the right to occupy air space.[107] The court, in an effort to ensure that the city received its tax money, found a way to make air rights taxable as land.[108] To reach its holding, the court conceded that air rights did not fit squarely

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[95]T.C.M. (CCH) 592 (1990).

[96]*Id.*

[97]*Id.*

[98]*Id.* Expert witness opinions indicated that the highest and best use of the property might include the addition of more stories.

[99]*Id.*

[100]Bigman v. Allegheny County Bd. of Prop. Assessment, 533 A.2d 778 (Pa. Commw. 1987).

[101]533 A.2d 778 (Pa. Commw. 1987).

[102]*Id.* at 779

[103]*Id.* at 778

[104]*Id.*

[105]*Id.*

[106]*Bigman*, 533 A.2d at 778.

[107]*Id.* at 779.

[108]*Id.* at 780.

within either the definition of a building or land.[109] The court asserted that "air space is certainly not a solid part of the earth's surface;" thus, it must be considered a building.[110]

The appeals court agreed with a lower court's findings.[111] The lower court, however, struggled with the conceptualization of air rights. Having established that air rights existed in structures, the lower court had to rectify the problem of potentially double taxing someone on the air rights and the building rights for the same space.[112] Perhaps a better solution would be for the court to acknowledge that once a structure is built, an air right becomes vacated until such a time as the building is destroyed, thus allowing the air right to exist again. This contention leads to the assertion that air rights and building rights are mutually exclusive.

This *Bingham* decision overlooks the fact that air space is not part of the structure of a building. The court determines that because air space can be encapsulated within a building, it is therefore, part of the building's interest.[113] To extend this holding would require that the air space adjacent and superjacent to a building could not be part of the land interest. Furthermore, if the building were demolished would the air rights be lost forever? Of course not, a new building would be constructed in the air space that still remains above the land.

The Tax Court has faced similar questions to that of *Bingham*.[114] They have not yet ruled on the specifics of which interest an air right attaches to; therefore, this question remains unanswered at the federal level.

In *Grey v. Coastal States Holding Company*,[115] a Connecticut intermediate court held that a building which is superjacent or adjacent to an individual condominium, and into the "common element" of air space, was a violation of the cooperative agreement between the two parties.[116] The court stated that it was elementary to state "what is not a unit must be a common element."[117] This is important for purposes of our analysis as it establishes another distinction between a building and the space around it.

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[109] *Id.* at 781.

[110] *Id.*

[111] *Bigman*, 533 A.2d at 703. ("While we tend to agree with Judge Wekselman's ultimate conclusion, we note that Taxpayers have not questioned the total assessment of their property").

[112] *Id.* Judge Wekselman concluded that an owner of a condominium, whose air rights are completely filled by the structures that they own should not be charged with an additional assessment for them.

[113] *Id.*

[114] *Mattie Fair*, 27 T.C. at 872.

[115] 578 A.2d 1080 (Conn. App. Ct. 1990).

[116] Grey v. Coastal States Holding Co. 578 A.2d 1080, 1084 (Conn. App. Ct. 1990).

[117] *Id.* at 503.

2. Using Facade Easement Provisions as Guidance.

In the Treasury Regulations, the I.R.S. does delineate a policy on basis adjustment, with respect to the allocation of basis for facade easements.[118] It requires a pro rata allocation of the reduction in value between the land and the building.[119] This concept is further described in an Example 12 of Treasury Regulation Section 1.170 A-14(h)(3)(iii).[120] In this detailed description of an easement transaction, the I.R.S. again advocates a pro rata basis reduction.[121] In this example, however, the easement's effect on the building's value is specifically mentioned. An easement in which the reduction in the value affects only the land is not addressed.

In General Counsel Memorandum 39794, the government established that in a case of a certified rehabilitation for tax credit purposes, there are three basis accounts: the land, the shell and the rehabilitation costs.[122] This memorandum goes on to establish that "[i]n theory, the grant of a facade easement reduces the value of the land, the shell [outside of building], and the rehabilitation that the taxpayer continues to hold."[123] The I.R.S. concludes that it would be appropriate to reduce all

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[118]Treas. Reg. § 1.170A-14(h)(3)(iii) (2002) ("When a taxpayer donates to a qualifying conservation organization an easement on a structure with respect to which deductions are taken for depreciation, the reduction required by this paragraph (h)(3)(ii) in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land").

[119]*Id.*

[120]*Id.* at ex. 12. ("F owns and uses as professional offices a two-story building that lies within a registered historic district. F's building is an outstanding example of period architecture with a fair market value of $125,000. Restricted to its current use, which is the highest and best use of the property without making changes to the facade, the building and lot would have a fair market value of $100,000, of which $80,000 would be allocable to the building and $20,000 would be allocable to the lot. F's basis in the property is $50,000, of which $40,000 is allocable to the building and $10,000 is allocable to the lot. F's neighborhood is a mix of residential and commercial uses, and it is possible that F (or another owner) could enlarge the building for more extensive commercial use, which is its highest and best use. However, this would require changes to the facade. F would like to donate to a qualifying preservation organization an easement restricting any changes to the facade and promising to maintain the facade in perpetuity. The donation would qualify for a deduction under this section. The fair market value of the easement is $25,000 (the fair market value of the property before the easement, $125,000, minus the fair market value of the property after the easement, $100,000). Pursuant to § 1.170A-14(h)(3)(iii), the basis allocable to the easement is $10,000 and the basis of the underlying property (building and lot) is reduced to $40,000" *Id.*). This example offers some clarification, particularly for a property owner who is donating a facade easement. It fails to clarify the provisions of Section 1.170A-14(h)(3)(iii) with respect to the "properly allocable" language. *See id.* Particularly, to what are air rights properly allocable to? *See id.*

[121]*Id.* Facade easements differ from air rights easements in that they are designed to have a direct effect on the buildings exterior. *Id.* Even incidental encumbrances on adjacent air space are usually not allowed by deed for façade easements. *Id.*

[122]Gen. Couns. Mem. 39,794 (July 13, 1989) issued to support Rev. Rul. 89-90, 1989-30 I.R.B. 4 (1989).

[123]*Id.*

of these properties in proportion to which the granting of the easement reduces the fair market value of each part.[124] Bearing this in mind, if an easement were ruled to have no affect on the building and produce no reduction in value, one could conclude that such an easement did not affect one's rights in that building.[125]

C. Air Rights are a Sub-classification of Land Rights, Not of Building Rights

Imagine that for your birthday, you are given a square shaped cake. This cake is comprised of two layers and it is cut in the manner of a tic-tac-toe board, as to produce nine pieces. Due to a sudden increase in your popularity, eighteen people show up for your party instead of the nine you were expecting. In order to satisfy everyone, it is agreed that the top layer of the cake should be separated from the bottom layer, thus creating eighteen pieces from the original nine. When doling out the pieces to your new friends, you declare that everyone has a right to one piece. Would it be logical, or even possible, for the person who gets the top-center piece to also have a right to the bottom-center piece? To do this would leave someone else without a piece. Once the cake is separated vertically, the right to each piece of cake is mutually exclusive to the rights in any other of the other eighteen pieces. Visualizing the bottom-center piece as a building and the top center piece as superjacent air rights, it is hard to understand how one must be connected to the other for purposes of taxation, valuation, or otherwise.

From one millimeter above the land through to the heavens you are in "air space."[126] There is no interest in land, therefore, that involves above-ground activity, but does not affect some form of air rights.[127] The Supreme Court has recognized that property is the sum of rights and powers incident to ownership.[128] Thus, everyone with real estate owns air rights, whether they realize it or not. The Tax

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[124] *Id.*

[125] *See* Eastwood Mall v. United States, No. 4:92cv1089 (N.D. Ohio Apr. 14, 1995) (unreported). In this case a federal district court established a test for determining whether land preparation costs are associated with nondepreciable land or the depreciable building which rests on it. Judge Matia opined, "[t]he test … is whether these costs will be reincurred if the building were replaced or rebuilt." *Id.* By analogy then, the test to whether an air right easement is a building interest should be whether that right is adversely affected by the destruction of the building. Buildings will come and go but the rights to the air space above land will always remain regardless of what structures occupy certain portions of it.

[126] Note, *Conveyancing and Taxation of Air Rights*, 64 COLUM. L REV. 338, 341 (1964). ("Air rights, an independent unit of real property created through the horizontal subdivision of real estate, may be defined as the right to occupy the space above a specified plane over, on, or beneath a designated tract of land. The air itself is not real property and is not conveyed; airspace, however, is real property when described in three dimensions with reference to a specific locus" *Id.*).

[127] *Cf.* Bigman v. Allegheny County Bd. of Prop. Assessment, 533 A.2d 778 (Pa. Commw. 1987). In a case where the language of the Uniform Condominium Act, defining land and building rights, was inconsistent with the definition of air rights the court determined "[o]ne can have an interest *in* land and one can have an interest *over* land, but one cannot have an interest in land above the ground." *Id.*

[128] Nashville, Chattanooga & St. Louis Ry. v. Wallace, 288 U.S. 294, 268 (1933).

Court has determined that air rights are property interests because they represent one of the rights and powers incidental to the ownership of real property.[129] These property rights can be severed either vertically or horizontally.[130]

Once "severed" from the bundle of rights, property can be disposed of in any manner consistent with existing laws.[131] In addition, once an air right is severed, it may be distinguished from the land interest.[132] It is common knowledge that a building, as an individual asset, may also be severed from the fee interest in real property and sold or leased to another party.

The Tax Court addressed the issue of air rights deductibility for the first time in *Mattie Fair v. Commissioner*.[133] In *Mattie Fair*, the court was faced with a situation where petitioners donated the right to build five additional stories above an existing two story building to a private foundation, of which they were trustees.[134] The easement was not a conservation donation.[135] Rather, it was a positive easement for the foundation to exercise in the event they wished to actually build the five additional stories.[136] The court held that air rights were rights in property, and were deductible.[137] The court also asserted that there was no legal policy which should prevent air rights from being given legal status.[138] The court did, however, recognize that the severance of property into vertical and horizontal layers presented difficult issues for courts to tackle.[139] Because the I.R.S. did not ask for any additional deficiency relating to improper basis allocation, the court circumvented analysis of this issue.[140]

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[129]*Mattie Fair*, 27 T.C. at 872.

[130]Fasken v. Comm'r, 71 T.C. 650, 655 (1979). In *Fasken*, the court held that a sale of an easement in excess of basis results in capital gain, and goes on to note that the easement need not involve a 'vertical or horizontal severance of the realty into two or more parcels,' that '[o]wnership of property is not a single indivisible concept but a collection or bundle of rights with respect to the property,' and that as an easement is one of the bundle of rights comprising ownership in land, the granting of an easement constitutes a disposition of such interest. *Id.*

[131]Black v. Comm'r, 38 T.C. 673, 676 (1962). The ownership of real property consists of a bundle of rights, including the free use and enjoyment of the property, the right to control it, and the right to dispose of it in any manner not contrary to existing regulatory laws.

[132]Sullivan v. United States., 618 F.2d 1001 (3rd Cir. 1980). An owner can sever the rights incident to a fee interest in real property for purposes of a sale. *Id.* A severed interest is treated separately for federal income tax purposes. *Id.*

[133]*Mattie Fair*, 27 T.C. at 872.

[134]*Id.* at 868.

[135]*Id.*

[136]*Id.* at 871.

[137]*Mattie Fair*, 27 T.C. at 866.

[138]*Id.* at 872.

[139]*Id.*

[140]*Id.* at 875.

While air rights are still attached to the land, they are one of the components of the overarching real estate interest. This was established in a Maryland case involving a real property tax dispute.[141] In a case of first impression, the Maryland Court of Appeals in *Macht*, determined that severing the rights in air from the rest of the fee parcel of land makes air rights taxable.[142] This contention supports the position that air rights may be exclusive of other property rights. This case involved the owner of a large building that was located in urban real estate.[143] A different property owner wished to develop an adjoining parcel of land with another tall structure.[144] The two parties struck an agreement whereby one would pay the other for the right not to develop its structure to any higher level.[145] Air rights were discussed only as an interest in real estate.[146] There was no distinction made as to whether air rights were an interest in the land or the building.[147] This case helped to establish that for state tax purposes, air rights that are superjacent to buildings could be assessed separate from the building for tax purposes.[148]

There is no legal authority that attributes air rights to land that is laterally adjacent. When a situation arises where a fee holder of land also possesses an air rights easement on an adjacent parcel, that easement is not considered to be an interest in the adjacent parcel.[149] Contrast this with buildings, which can penetrate below ground, or extend laterally onto adjacent property.[150] Buildings are spatially independent of the air rights that are appurtenant to a given tract of land.[151] Air rights can only occur in the space a landowner can utilize above his ground and in

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[141]Macht v. Dep't of Assessments, 296 A.2d 162 (Md. 1972). A case where owners of adjacent urban buildings agreed to exchange an air rights easement so that one of the buildings would not be crowded out of light and air by the construction of the adjacent building. *Id.* The Maryland Court of Appeals held that until one is denied the ability to use air space, through vesting the right in another for money, it is not assessable for taxes. *Id.*

[142]*Id.*

[143]*Id.* at 164.

[144]*Id.*

[145]*Macht*, 296 A.2d at 164. The City of Baltimore determined that in 1969, the air rights had a value of $ 50,700. This establishes that if a statute will recognize the existence of air rights, and parties agree to a private contract relating to those rights, that a market rate can in fact be determined. *Id.*

[146]*Macht*, 296 A.2d at 166 (making a distinction between real and personal property, but fails to distinguish between land and building interests).

[147]*Id.*

[148]*Id.*

[149]*Id.* at 162.

[150]N.Y. Elevated R.R. Co. v. Comm'r of Taxes & Assessments, 82 N.Y. 459 (1880) (holding that elevated railway trestles were taxable as real property even though they extended over another parcel of separately owned land.)

[151]*Id.*

connection with his land.[152] Because of this distinguishable quality, it would be inappropriate to characterize building and air rights in the same manner.

Buildings do occupy air space, therefore, once a building is constructed, there is necessarily an interference with air rights.[153] One school of thought suggests that a building merely encapsulates air space, so that air rights are an interest in a building and not the land.[154] The problem with this reasoning is that such contained air space falls to the control of whomever has rights in the building. In effect, any rights attached to air space are lost once that space is contained within a structure.

Additionally, the utilization of air space around or above a building in no way affects ones right to use the building.[155] Buildings may be erected and destroyed within a given space without interfering with the rights to adjacent or superjacent air space pertaining to a certain tract of land. Therefore, the I.R.S. should consider air rights and rights in a building to be mutually exclusive components of the greater fee interest in a given tract of real property.

Another question pertaining to air rights is how to deal with the air rights on laterally adjacent land. The Treasury Regulations do provide guidance as to how we should treat air rights in adjacent parcels of property with respect to the piece of property to which they abut.[156] In order to clarify the adjustment of basis when an

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[152]*Macht*, 296 A.2d at 604.

[153]*Mattie Fair*, 27 T.C. at 872. The Tax Court determined that air rights were frequently the most valuable rights in land because they defined the space in which structures could be erected. *Id.* There was no mention that these air rights are rights in buildings. *Id.* The court held that the rights and interests contributed were property with a fair market value of not less than $ 70,000 and such gift was deductible to the extent provided in § 23of the Internal Revenue Code of 1939. *Id.*

[154]*Bigman*, 533 A.2d at 778.

[155]*Cf. id.*

[156]Treas. Reg. § 1.170A-14(h)(4) at ex. 10 **(1999).** ("E owns 10 one-acre lots that are currently woods and parkland. The fair market value of each of E's lots is $15,000 and the basis of each lot is $3,000. E grants to the county a perpetual easement for conservation purposes to use and maintain eight of the acres as a public park and to restrict any future development on those eight acres. As a result of the restrictions, the value of the eight acres is reduced to $1,000 an acre. However, by perpetually restricting development on this portion of the land, E has ensured that the two remaining acres will always be bordered by parkland, thus increasing their fair market value to $22,500 each. If the eight acres represented all of E's land, the fair market value of the easement would be $112,000, an amount equal to the fair market value of the land before the granting of the easement. (8x$15,000 = $120,000) minus the fair market value of the encumbered land after the granting of the easement (8x$1,000 = $8,000). However, because the easement only covered a portion of the taxpayer's contiguous land, the amount of the deduction under section 170 is reduced to $97,000 ($150,000-$53,000), that is, the difference between the fair market value of the entire tract of land before ($150,000) and after ((8x$1,000) + (2x $22,500)) the granting of the easement." *Id.*

Treas. Reg. § 1.170A-14(h)(4) at ex. 11 **(Year)** (Assume the same facts as in example (10)). Since the easement covers a portion of E's land, only the basis of that portion is adjusted. *Id.* Therefore, the amount of basis allocable to the easement is $22,400 ((8x$3,000) x($112,000/$120,000)). *Id.* Accordingly, the basis of the eight acres encumbered by the

easement is donated that only affects eight out of ten one acre lots, the I.R.S. states that only the basis of those eight parcels should be adjusted.[157] Assuming that severing a parcel vertically had the same affect on the value of a parcel as a horizontal severance, it would be appropriate to accord the laterally adjacent air rights with the same treatment as the vertically adjacent ones.

In addition to easement fact patterns, the Tax Court has examined another line of cases, which involve superjacent air rights. In the typical garbage dump case, an owner pays extra money for a parcel of land that has a huge hole.[158] The question is whether premiums paid on this land are depreciable business expenses.

Where a Chicago dump operator sought to depreciate the cost of his investment in land that had a depression forty feet below street level, the court held when a premium is paid for "space" in an excavated parcel of land, and where the taxpayer could establish annually how much space was filled, it is proper to consider this "space" a wasting asset, which is depreciable for tax purposes.[159] Here, the space was an excavation by a brick company that operated out of that land.[160] The purchase by the petitioner was made with both parties knowing that the land would be used as a landfill.[161]

In dicta, the Tax Court noted that "rights in space have been recognized as property subject to transfer separately from the related land."[162] Seemingly, the Tax Court has acknowledged that on parcels without buildings, the space relates to the land. It does not make sense to state that when a building is added to the equation, those rights to "space" become part of the building. That logic would leave open space above and around a building unaccounted.

Some of these garbage dump cases extend into above-ground space. A 1987 garbage dump case involved a taxpayer who sought to depreciate costs associated with a premium paid for the right to fill space.[163] In *Browning-Ferris v. Commissioner*,[164] the petitioner, a large national solid waste disposal company, depreciated the value of its property in proportion to the amount of fill that was expended into the below ground and above ground waste disposal areas.[165] The

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easement is reduced to $1,600 ($24,000-$22,400), or $200 for each acre. *Id.* The basis of the two remaining acres is not affected by the donation. *Id.*

[157] *Id.*

[158] *See*, *e.g.*, Sexton v. Comm'r, 42 T.C. 1094 (1964); Golden Gate Disposal Co. v. Comm'r, T.C.M. (CCH) 835 (1979); Sanders v. Comm'r, 75 T.C. 157 (1980). In a case where the depression was a natural, not manmade hole, the Tax Court concluded that the value of the depreciable interest was equal to the value of the land before, minus the value of the land after dumping was complete.

[159] *Sexton*, 42 T.C. at 1094.

[160] *Id.*

[161] *Id.*

[162] *Id.* at 1102.

[163] Browning-Ferris Indus., Inc. v. Comm'r, 53 T.C.M. (CCH) 397 (1987).

[164] 53 T.C.M. (CCH) 397 (1987).

[165] *Id.*

I.R.S. contended that the space used by Browning-Ferris was not depreciable.[166] The Tax Court disagreed.[167] In order to reach its holding, the Tax Court concluded that distinctions about the topographical characteristics of land were irrelevant, and what mattered was the suitability of the land for dumping.[168] The court held that the above ground space acquired and utilized for waste disposal constituted depreciable property.[169]

If superjacent air rights are a depreciable asset, it would be an uneasy fit with the definition of land, which according to the I.R.S., is not depreciable.[170] Deductions are a matter of legislative grace.[171] The taxpayer has the burden of meeting the depreciation criteria.[172] As a result, if the purpose of the donation of an air rights easement was for conservation, not for use as a wasting asset, then much of the garbage dump depreciation tenets would be inapplicable to qualified conservation easement donation regulations. On the other hand, determination of the properties of "space" carry no burden of proof and should bind the courts regardless of the individual fact patterns classification as either a depreciation or a qualified conservation easement donation's.

For powerful persuasive evidence of the I.R.S.'s rationale surrounding the interest affected by an air rights easement, the Revenue Rulings outline the federal government's position.[173] In a situation where an air rights easement results from threatened governmental condemnation, that easement may be depriving a taxpayer of all the beneficial interest in that portion of land.[174] Again, the government recognizes that air rights affect an interest in land. Unfortunately, this ruling applied to I.R.C. Section 122(f) and may be found inapplicable to our fact pattern.[175]

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[166]*Id.*

[167]*Id.*

[168]*Browning-Ferris*, 53 T.C.M. (CCH) at 397.

[169]*Id.*

[170]I.R.C. § 170(h)(3) (2001).

[171]New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

[172]I.R.C. § 170(h)(4)(A) (2001).

[173]Rev. Rul. 54-575, 1954-2 C.B. 145 (1954). ("A transaction whereby proceeds are received as the result of granting an easement of air rights over certain land under threat of Government condemnation and the granting of such an easement deprives the taxpayer of practically all the beneficial interest of a portion of the land, covered by the easement, except for his retaining only the mere legal title thereto, is considered to be a sale of that portion of the land and any gain realized from such sale will be subject to the relief provisions of section 112(f) of the Internal Revenue Code of 1939. The consideration received for granting the easement over the portion of the land where beneficial interest is retained by the taxpayer may be used to reduce the cost or other basis of such land and any excess of the payment over the cost or other basis is taxable gain. Any recognized gain is considered as having been realized in connection with an involuntary conversion and is subject to the limitations provided by section 117(j) of the Code"). *Id.*

[174]*Id.*

[175]*Id.*

IV. CONCLUSION

Despite some discrepancies in the opinions of various state and federal law making or interpreting entities, the weight of arguments seem to support the conclusion that air rights are an interest in land separate from a building. For simplicity, the I.R.S. should adopt this position in the form of a new regulation or ruling. Such a ruling would not only be a proper conciliation of the current legal gap, but would serve the overall intent of Congress.[176]

This position is proper because much of the I.R.S. authority in the area of easements allows for the tracing of costs directly to individual parcels, and parcels should not be treated differently because they are laterally or vertically adjacent to one another. Additionally, air rights easements run with the land and exist regardless of the structural development on a given tract of land.

Presently, there are very few attorneys who would petition the I.R.S. for a letter ruling in fear that this could cause an adverse opinion. Many easement donors consider it safer, to wait and take a chance in court. This "wait and see" approach has lead to problems in other areas, such as inflated deductions associated with real estate tax planning.[177] These problems could threaten the whole easement program. In any event, the uncertainty in the marketplace of ideas is clearly having a hindering affect on potential historic preservation projects.

By augmenting the array of benefits available to potential conservation easement donors, the amount of easements granted and the amount of buildings preserved should increase. Property owners will always act with their own personal interest in mind. That said, a tremendous loss could be suffered if historic structures are allowed to be destroyed while the government debates the merits of another tax break for wealthy urban real estate owners. When Congress enacted tax provisions allowing for conservation easements to be deductible, it was making a concerted effort to preserve history.[178] It would seem appropriate to further that purpose by construing the current vagueness in a manner that benefits preservation. The alternative is a wrecking ball, and its affects are irreversible.

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[176] *See* Comment *supra* note 1.

[177] STEPHEN J SMALL, THE FEDERAL TAX LAW OF CONSERVATION EASEMENTS 15 (4th ed. 1997 & Supp. II 1995). Analyzing the Dorsey v. Comm'r case, the writer observes that in the past few years there has been an increasing amount of I.R.S. audits surrounding easement deals on historic structures. Apparently, in cases where developers have argued that huge buildings could be constructed on dilapidated old structures, the I.R.S. has disagreed. They have instead taken the position that while some deduction may be allowable in excess of basis plus rehabilitation costs, that astronomically high valuations are not feasible. Apparently, this represents an alteration of the "highest and best use doctrine". *Id.*

[178] *Id.*